

# Moscow Financial Weekly

For the Week Ending October 26, 2001  
Treasury Attache's office, US Embassy Moscow

## Highlights This Week

- GOR approved plan to reform Vnesheconombank (VEB)
- Dust up over corporate governance at Sibneft
- **Weekly Focus:** Corporate Governance

## Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/\$ (MICEX) UTS	29.6316	0.28	5.21
Monetary Base*	R675.4 bln	0.09	39.92
CPI	NA	0	13.9
International Reserves*	\$38.6 bln	0.00	36.40
RTS Index (end of week)	199.09	4.25	39.91
Refinancing rate	25	0	0

\*For week prior

## Economic Developments

Capital flight in Russia during the first half of 2001 was approximately \$10 billion, in line with last year's capital flight rate. This figure is consistent with FDI and portfolio investment figures and with previous BoP numbers that showed little evidence of a slowdown in capital flight. Anecdotal evidence of Russian offshore money returning and renewed interest from foreign investors has been abundant this year and it is somewhat surprising that nothing has shown up in the numbers. Still it appears that Q3 numbers will show a sharp drop in capital flight to \$4-4.5 billion from \$6 billion. This would be a signal that purchases of Russian companies booked offshore earlier this year are now leading to investment financed by repatriated earnings.

At the World Economic Forum, President Putin previewed additional tax reform plans, specifically a plan to reduce the VAT from 20% to 15%-16% while reducing or eliminating special exemptions (ex: pharmaceuticals and some basic foods are taxed at 10%). While there had been some prior indication that the GOR was working on extending the model of lowering the rate and expanding the base that was used in this year's profit tax reform, this would seem to make new tax reform very likely. With some of the GOR's more controversial reforms such as judicial, debureaucratization, and currency liberalization all

Sibneft this week became involved in a new high-profile corporate governance dust-up. The incident is significant less for the extent of abuse to minority shareholders - it is not clear to what extent shareholders really suffered - but for the fact that it undermines what many had thought was a sincere effort by Sibneft to improve its corporate governance

reputation. After Sibneft announced high net profits for the first quarter on October 22, which pushed its share price up by 10%, the company announced that a block of 27% of the company's shares held as treasury stock, had been sold in July to the major shareholders, Roman Abramovich and his associates. The sale happened to take place right before a large dividend payment in August. Since the July sale price for the shares of \$568 million was 4.5% over the purchase price, the sale was presumably not a calamity for shareholders. Nevertheless, the market was shocked by the non-transparency of the deal and the prices fell 20% in the morning of October 23, recovering by the end of the day, but still 10% short of the prior day close. The following week, Sibneft explained the sale as simply legal tax avoidance, but damage was done. This incident came the same week that the majority of Sibneft shares were consolidated into a holding company, Millhouse Capital, representing Abramovich's holdings. Although Sibneft's was never famous for its transparency, recent positive developments in its corporate policies gave the hope that it was becoming more attentive to the needs of its shareholders. Instead what this incident seems to highlight is that minority shareholders in major Russian firms remain at the mercy of the dominant shareholders. Corporate governance charters and new investor relations departments notwithstanding, these shareholders tend to act in their own interests without consultation making returns to investors unpredictable. The "Russia discount" is not likely to disappear soon. [More on this in this week's Focus].

### **Banking sector**

On October 25 the GOR discussed and approved "in general" the plan to reform Vnesheconombank (VEB). The plan is to be finalized by December 1, 2001 and implementation will begin in Q1 2002. As of today, the concept stipulates that assets and liabilities of the "commercial part" of VEB will be passed to Roseximbank, which then will change its name to Vnesheconombank of Russia. Charter capital of the latter will reach about \$2 billion. Attracting foreign investment and servicing export contracts will be its main functions. Vnesheconombank of the USSR will retain the function of state debt servicing and in three years would be reorganized into the Debt Agency of the RF. The somewhat odd decision to preserve the title "Vnesheconombank of the USSR" relates to its continued mandate as the agent for external debt, the majority of which is Soviet-era. VEB Chairman Kostin said after the GOR meeting that Prime Minister Kasyanov also had raised the issue of a possible future merger of the new commercial Vnesheconombank of Russia and Vneshtorgbank (VTB). If this idea were implemented (which does not seem likely), a wholly state owned bank with capital of about \$4 billion would be created. Adding to the capital of an already-too-powerful VTB would be, if it were to happen, a step backward in Russia's efforts to create a competitive, efficient banking sector.

According to CBR Deputy Chairman Georgy Luntovsky, on Saturday, October 27, the Finance Ministry was supposed to deliver the revised version of the Joint Strategy for Banking Reform to the GOR. (The GOR approved the document "on the whole" on September 27 and allowed a month to finalize it). President Putin is then supposed to discuss it with CBR Chairman Geraschenko this week. The focus of the discussion would center on the advisability of having minimal capital requirements. According to Luntovsky, currently the Ministry of Economic Development and Trade proposes to set the minimal capital norm for all banks at 10 million Euro (note: Deputy Min Econ

Minister Dvorkovich recently said his Ministry could support a 5 million Euro minimum), Finance Ministry stands for 5 million Euro and there are other agencies that recommend one or two million Euro as the threshold. The CBR insists that no minimal capital requirement is needed at all, advocating a significant increase of the capital adequacy requirement instead.

The CBR has drafted amendments to the Civil Code that would provide better protection to creditors whose claims are collateralized. The GOR will discuss the amendments designed to reduce the risks associated with lending to the real sector in November.

On October 23 Aleksandr Smolensky, the head of "Financial-Industrial Federation" holding and founder of SBS-Agro group, announced that North-Western OVK bank, formerly St.Petersburg-based, had been re-registered in Moscow under the name Bank of Project Finance "Stolichny". ("Stolichny" is name of his first bank. Later it was renamed into Stolichny Bank of Savings (SBS) and after the acquisition of Agroprombank became SBS-Agro, which failed in 1998 and now is in receivership.) Smolensky said that in the future 90% of the new "Stolichny" would be sold to a foreign investor, but refused to specify to whom exactly. The reestablishment of the Smolensky banking empire is a good barometer about the system's ability to enforce "fit and proper" rules on banks.

The working group on the law on the Central Bank has finalized its plan for the CBR to quit the capital of Sberbank, Vneshtorgbank and CBR's foreign subsidiaries. According to the legislative amendments prepared by the group, the CBR may quit the capital of Sberbank no sooner than a year after the system of deposit guarantees has been created. It has to quit the capital of VTB by January 1, 2003. It will have to divest the daughter banks within a year from the time the new version of the Law on the Central Bank comes into force. Procedures for quitting the capital of these banks will be defined by a special bill. The work of this group and the GOR banking reform plan will have to be reconciled before legislation on these questions can move forward.

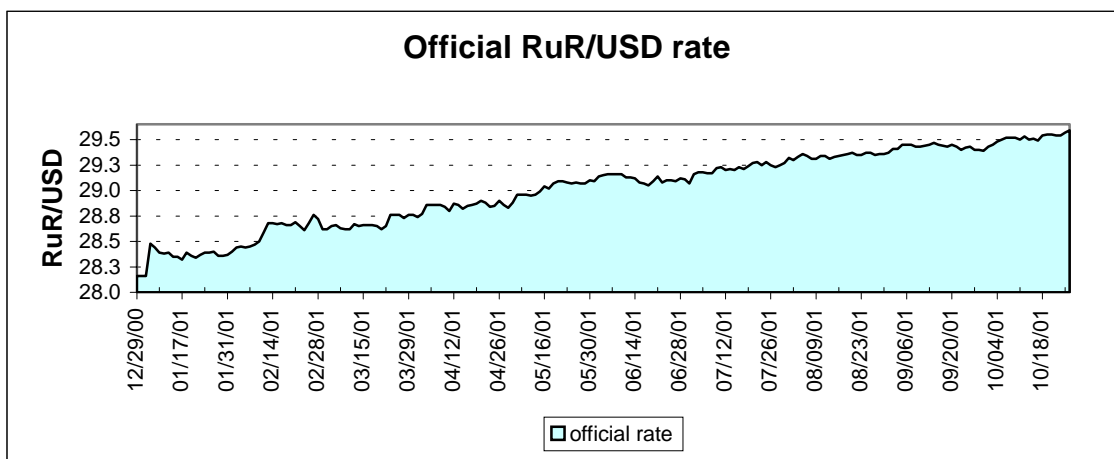
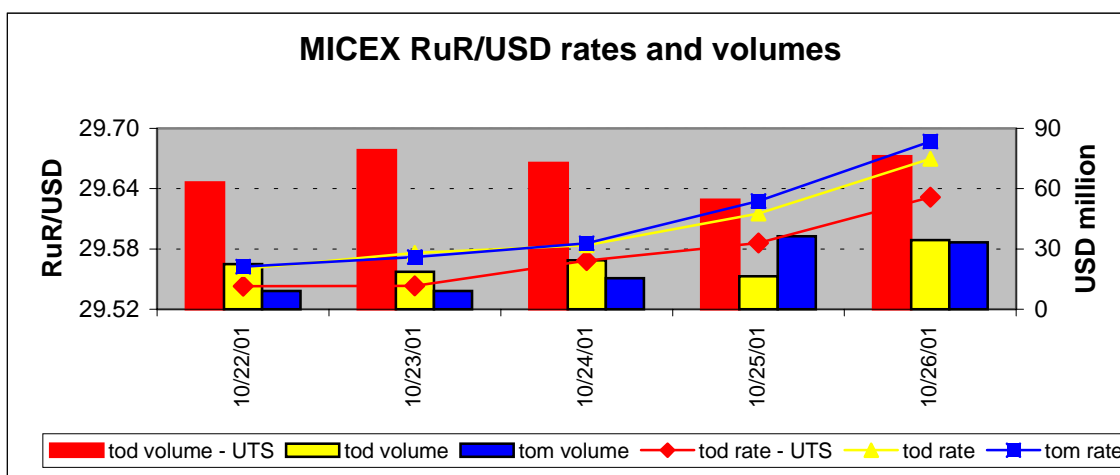
A \$50 million currency auction for non-residents holders of "S" accounts took place on October 29. Demand for dollars slightly exceeded supply, the CBR said. The currency bought at the auction may be repatriated without any restrictions. According to CBR Chairman Geraschenko, the CBR will hold another such auction in November and, possibly, one more by the end of this year.

## **Financial markets**

### **Forex Market**

In the first two days of the week the ruble inched up in the MICEX UTS against the dollar, but on Wednesday began rapidly devaluing on an abundance of ruble liquidity and reduced supply of dollars by exporters. The pace of devaluation - 900 points in 3 days was the highest since February. The CBR apparently did not intervene.

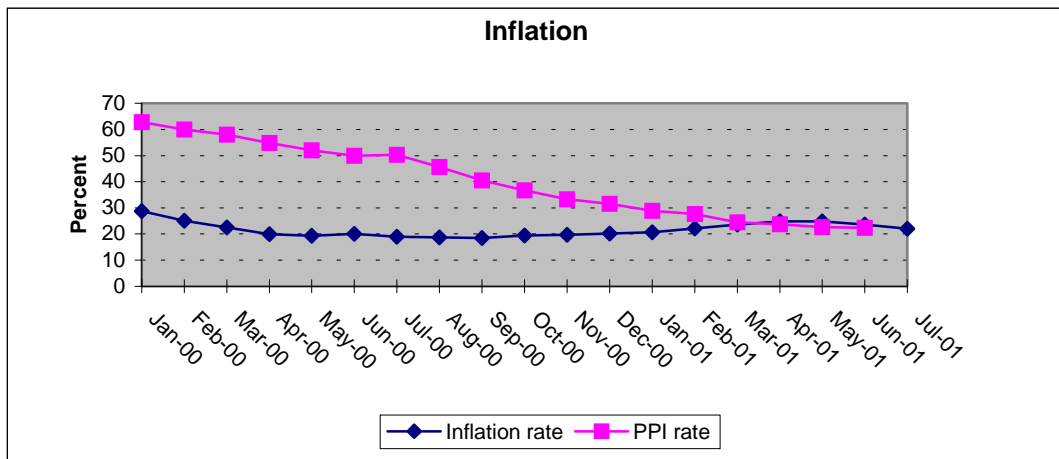
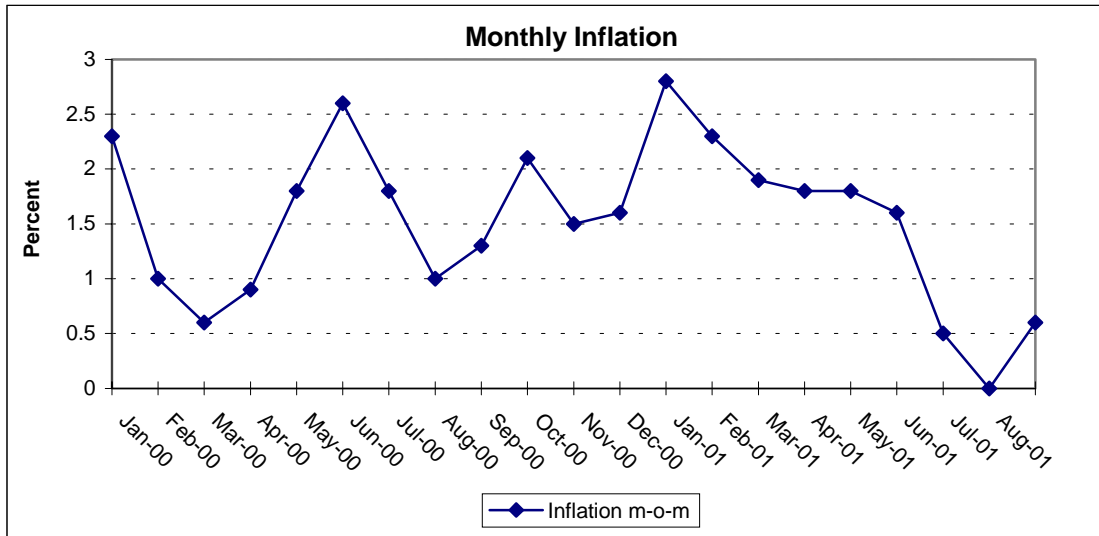
For the week the ruble weakened 0.28%, closing in the UTS on Friday at 29.6316/\$. MICEX weekly trade volumes were \$345.53 million, \$116.38 million and \$103.26 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.



## Prices

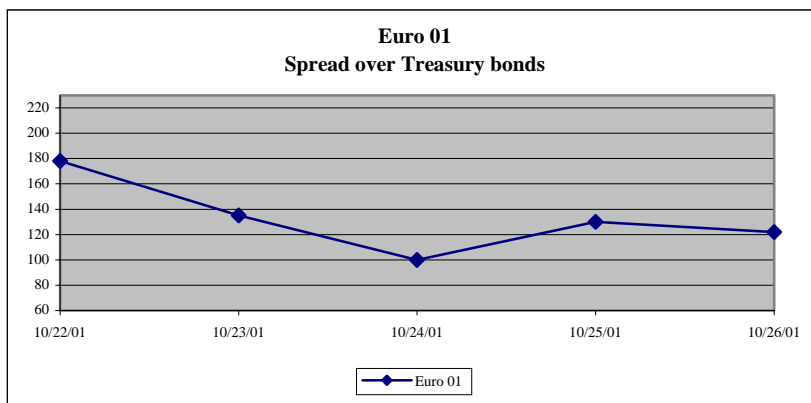
The inflation rate during the first 22 days of October was 0.8%. During the week of Oct.16-22, price growth accelerated and totaled 0.3%, compared to 0.2% a week before. At this rate, the monthly inflation would be around 1.1-1.3%.

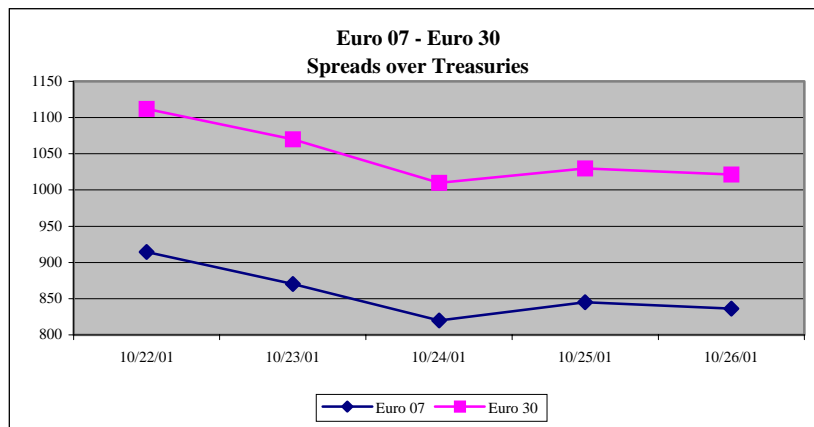
According to the Ministry of Economy, inflation will slow down to 11-13% in 2002-2003 and 8-10% in 2004. (The official 2001 forecast is 16-18%.)



## Eurobonds

Yields were down the beginning of the week based on positive dynamics on world stock markets. By the end of the week, overall markets began to fall on fears over Argentina and Turkey; however, Russian bonds performed better than the rest of the emerging markets.



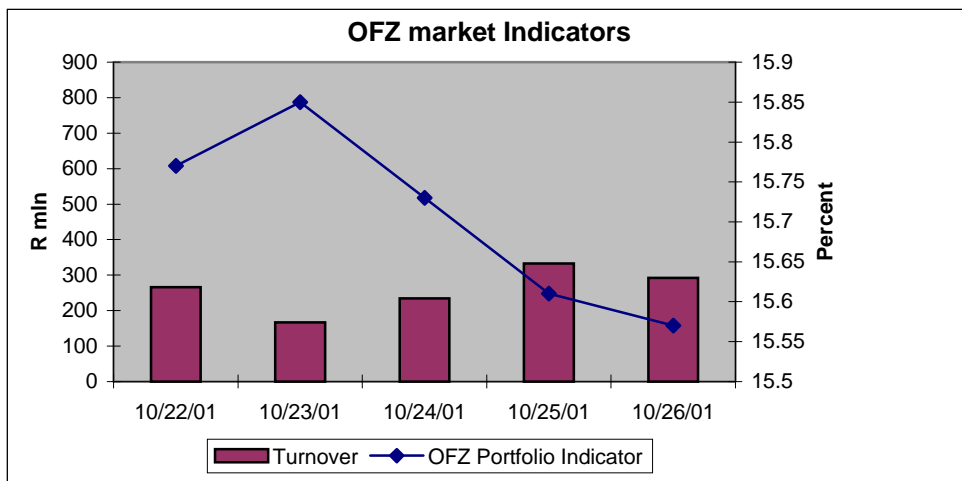


## Interest/Bond Market

### *Bonds/Bills*

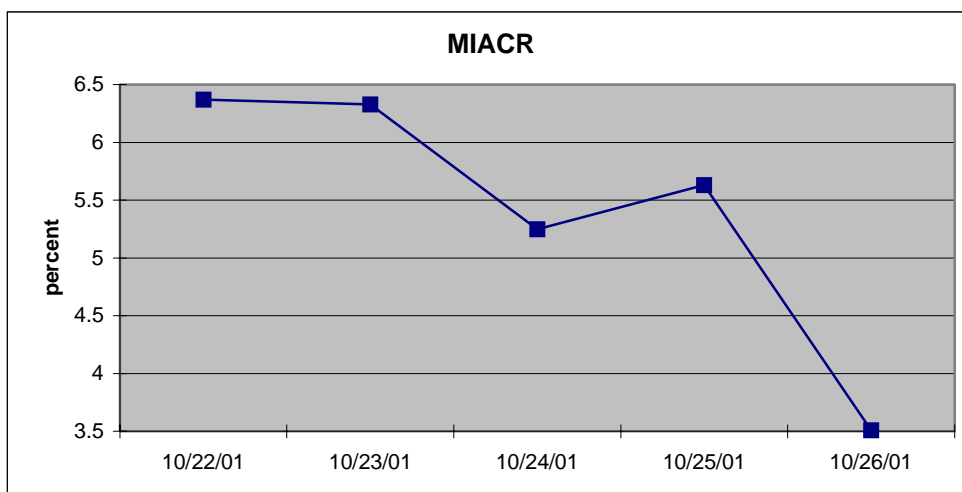
Prices on the secondary OFZ/GKO market rose last week, affected mostly by increased ruble liquidity. Growth was in the context of low volume due to unattractively low yields.

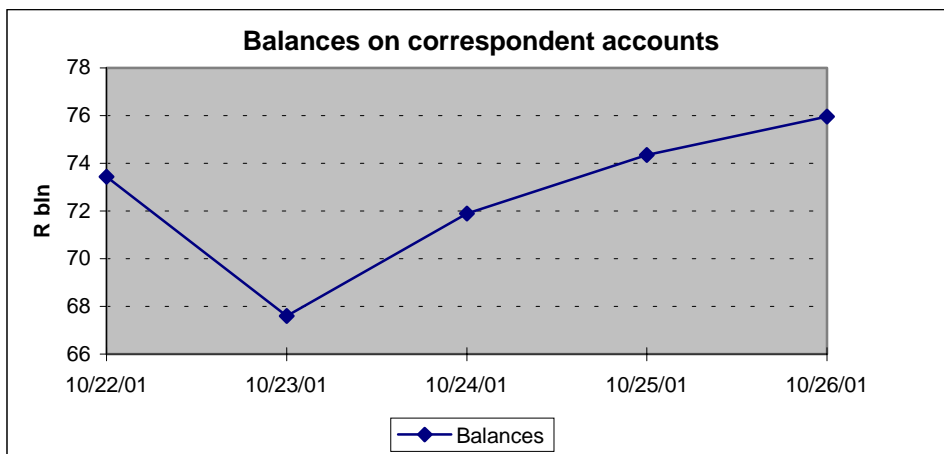
Last week, the Finance Ministry disclosed the details of an upcoming OFZ swap. Two weeks ago, the Ministry has announced the possibility of a swap of the largest current OFZ issue (R32 billion were put in circulation as part of the debt restructuring after the 1998 crisis, redeemable this December.) Last week, Deputy Finance Minister Bella Zlatkis said that the investors would be offered R18 billion of OFZs to be redeemed in August 2003 and short GKO with the maturity date in June 2002. Around 50% of the OFZ issue is held by Sberbank, so the market players do not doubt that the auction will be successful if the Ministry agrees with Sber (as it usually happens). The auction is to be held on November 21 for the OFZ papers and on November 28 for the GKO issue. Ms.Zlatkis also assured market players that the Ministry is able to redeem the whole issue; however, she voiced concerns about the large liquidity injection to the market in December at a time when the currency rate is seasonally unstable.



### *Overnight rates*

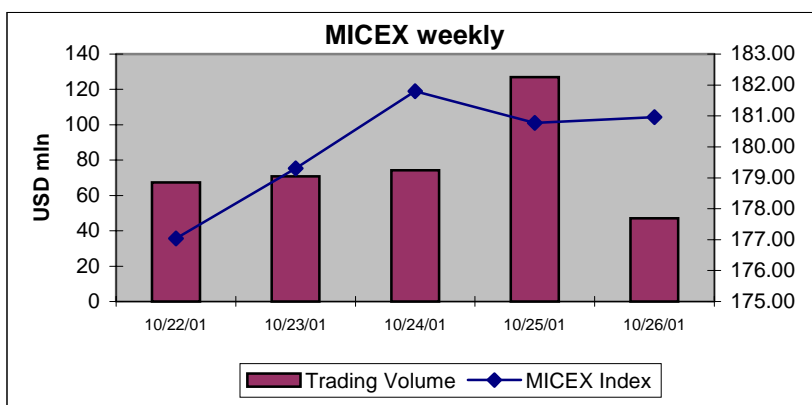
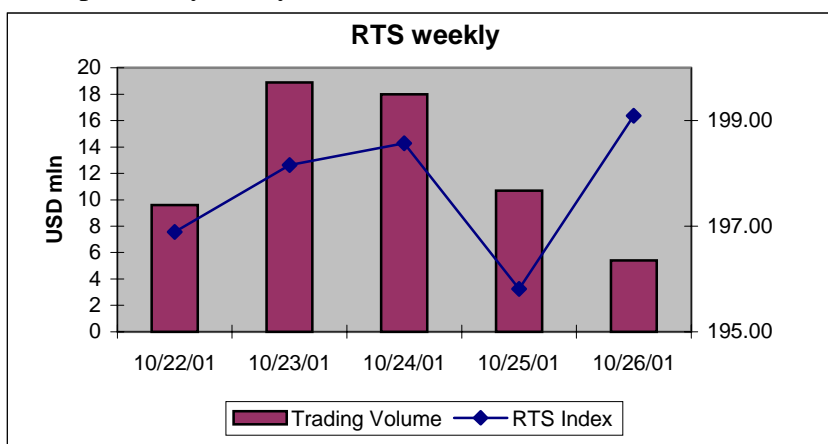
The expectations of the market players about a ruble deficit on the market as a result of tax payments was not realized. Balances on banks correspondent accounts at the CBR were up all week after a drop on Tuesday. This caused the overnight ruble loan rates to drop down to record low levels of 1-3% p.a. on Friday (MIACR stood at 3.51% p.a. that day.).



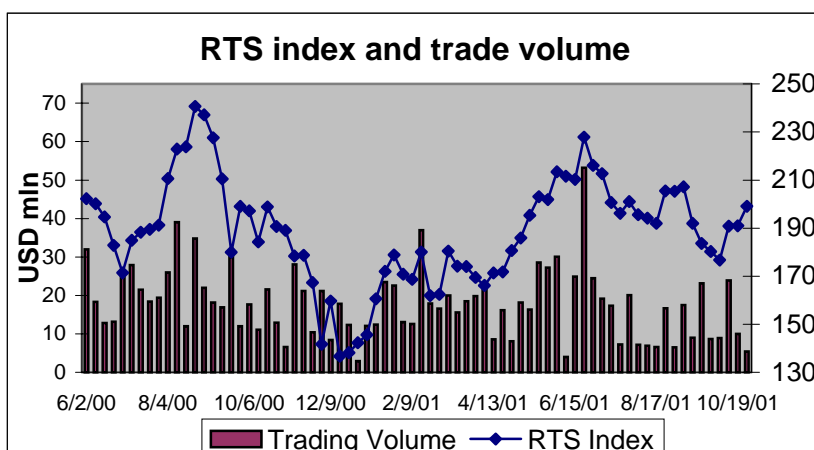


### Stock Market

The stock market rose during the first three sessions of the week and pierced the important psychological level of 200 several times though was unable to stay there. The market was supported by growth on the world markets as well as an increase in the oil prices. On Thursday it was down due to the technical corrections and at the end of the week index grew to 199.09 level - up by 4.25% for the week in real terms. Trade volumes were on average levels during the week, however, on Friday the growth was accompanied by a very low volume of \$5.4 million.



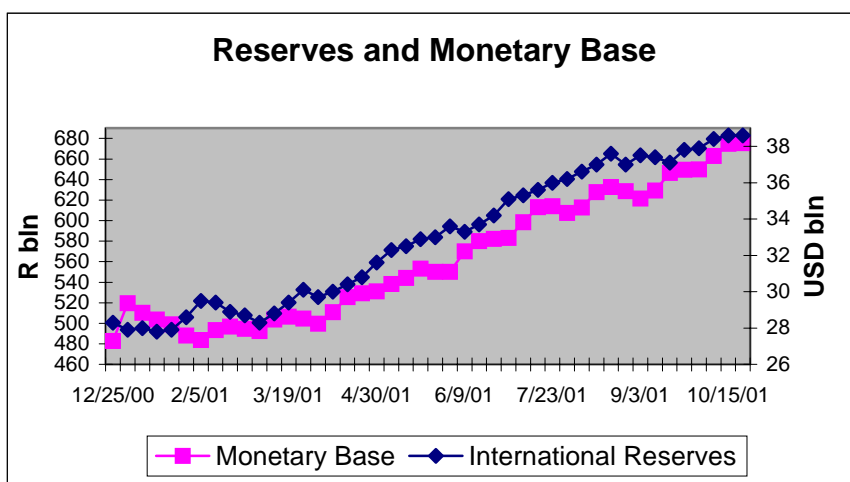




### International Reserves and Monetary Base

International reserves of the Finance Ministry and Central Bank remained unchanged during the last week and totaled \$38.6 billion - 36.4% or \$10.3 billion higher than at the beginning of the year. The lack for the normal weekly increase coincides with prepayment of IMF debt.

Monetary Base growth slowed down last week. It was up by 0.09% or R600 million and totaled R675.4 billion.



## **What difference does the new Corporate Governance Code make ?**

Strikingly good macroeconomic data, improvements in Russia's relations with Western Europe and the U.S. and signs that Russian offshore money is beginning to return seem to have caused foreign investors to take a renewed look at investing in Russia. A string of trade missions and investor conferences have generally given high marks, leaving the impression that we are may be at the brink of a 1997-like inflow of capital from investors looking for a harbor in the choppy emerging market seas.

The key factor holding things back, besides some misgivings about reliance on high oil prices, is corporate governance. Here Russian companies trade at a huge discount to their peers in more developed countries, some based on past abuses of outside shareholders, others simply due to the "Russia discount". The new Corporate Governance Code, which should come into force by the end of this year, is meant to be a major step in addressing this problem. But is it realistic to think that a mostly voluntary code will have an impact in practice? This week we look at the likely affect of the Corporate Governance Code compared to other incentives and disincentives for improving corporate governance.

### **Status of the Code**

A draft corporate governance code was introduced for public comment on September 18. It was prepared with industry participation and good cooperation of both Russian and foreign experts, it has been endorsed by business groups and the main international financial institutions and the Duma Securities committee. All in all, the code looks to be on track for final government approval by the end of the year.

One of the key dilemmas in designing the code was whether to make it voluntary, or at most the basis for self-regulation, as opposed to simply using it as a road map for future legislation and regulation. The decision was for a voluntary code, following the model of many western countries. The benefit of this approach is that the code can act as a model for best practices and as a true benchmark for comparing Russian companies' behavior against companies in developed countries. A code that simply consists of a compilation of current and future securities laws by definition be would have to be set at the level of lowest common denominator. Making a voluntary code work however means that the market itself must provide the discipline, including through self-regulatory agencies.

### **Problems with the Code?**

As in any project of this nature, it has its critics. Some of the largest Russian companies are concerned that the code gives minority shareholders too many rights, including the ability to block transactions. On the other hand, some believe the code sets impossibly high standards. Recommendations like having three independent board directors (few companies even have one) and using electronic voting are cited. The feeling is that if companies can't meet all of the code's standards they may be less inclined to meet the ones they realistically can.

Other problems relate more to securities laws than to the recommendations of the code itself. For example, in Russia, the trigger point for disclosure of ownership in the firm is 20 percent, while in western countries it stands at 5-10 percent. The code addresses this, recommending fuller disclosure, but this is an area where there needs to be legal enforcement. The financial liability of auditors is also much lower in Russia, and the code does not address this point. Finally, fines for violation of securities trading and other laws related to corporate governance are too low to be a deterrent.

#### Will the code be more than a nice piece of paper ?

Nit-picking aside, if the code were to be nominally followed by even a portion of Russian companies it would represent a significant improvement in corporate behavior. The problem is that evidence so far is that corporate governance codes put in place by individual companies in Russia have been more talk than reality. Last week's Sibneft mini-scandal (described briefly in this week's weekly) is a good example (there are others, such as UES).

Market observers with short memories believed Sibneft to be in the vanguard of those Russian companies who had gotten the message on governance. Indeed Sibneft management brags that it was the first to adopt a corporate governance code in 1998. What is interesting is that the secret trading of a major portion of stock between the company and its majority shareholder did not violate Russian law or Sibneft's broadly worded corporate governance code even though it involved insider trading and withholding of important information. It *would* violate the new corporate governance code, which recommends that major corporate actions should be approved by either the board or shareholders themselves and prohibits using inside information for personal gain. That, however is not much different than the current situation when minority shareholders know they are being treated poorly but have generally not punished violators severely. The price of their shares already assumes a large amount of corporate governance risk so share prices tend to hold up when expectations become reality. If the code is voluntary it may not be much more effective than the voluntary codes adopted by companies largely for PR purposes.

#### Can it be made to work better

Market mechanisms that reward followers of the Code and punish violators are not likely to spring up without some help. The FCSM has proposed requiring companies with over 1000 shareholders to report their compliance with the code either as a legal obligation or in order to issue new shares. While clearly this would be helpful, there is a question as whether the FCSM could ensure the accuracy of these statements.

More important is probably the role of rating agencies. These already exist for a limited number of companies but since corporate governance is somewhat subjective, especially in the absence of some major transgression, different raters have come up with quite different ratings for potential corporate governance risk. With a uniform code in place presumably differences will narrow, but there is still the problem of companies "shopping" for ratings. And ratings only work if investors use them. While there is some statistical evidence that companies in Russia that follow better corporate governance

practices receive more investment, the case is not overwhelming and must be balanced against the incentives for bad corporate governance (ie. taking money from existing investors). For the code to be effective, investors will have to decide that it is better to invest in a transparent firm with a good track record, than to take a rider on company with an eye-popping P/E ratio but a poor record in treating its shareholders.

The final way to strengthen the Code would be to incorporate specific aspects into law and assess high penalties, either fines or jail sentences or both for non-compliance. This of course is out of keeping with the idea of using market incentives, but may nevertheless be effective. Specific areas for possible Duma action include: rules for voting on new share issuance; stricter standards on disposal of company assets during a bankruptcy proceeding; legalizing shares issued in privatizations before the 1996 law on stock companies was in place; rules for management voting on behalf of American Depository Receipt (ADR) holders; and insider trading.

### Conclusion

While many Russian companies actively participated in developing the Corporate Governance Code and say they support it, it appears it will take much longer for the code to be broadly internalized and incorporated into company policy. In trying to improve ones image with potential investors, the easiest step to take is to sign onto a code, particularly when times are good. The harder things are to divide earnings fairly even when the pie may be shrinking. Real transparency about actual – not simply nominal -- owners also seems to be a difficult step. Even companies with other wise good rating often have this as their Achilles heel. The code is by no means a panacea, and it may take another business cycle to know how much its principles have been taken to heart. Most however would agree that it puts some wind in the sails of the general improvement in Russia's investment climate.

### Questions or Comments?

Please send your questions or comments on this Weekly to ["ustreasu@online.ru"](mailto:ustreasu@online.ru).

### EXPLANATORY NOTES

**1. EXCHANGE RATES:** SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). "\$-tod" price is the price of the dollar with same day delivery. "\$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is \$100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

**2. INTEREST RATES:** Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

**3. STOCK INDICES:** The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

**4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION** represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

**5. MONETARY BASE (M1)** is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

**6. LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.